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RUEHBJ/AMEMBASSY BEIJING 4497
RUEHHK/AMCONSUL HONG KONG 5694
RUESLE/AMCONSUL SHANGHAI 8250
RUEHGZ/AMCONSUL GUANGZHOU 8849
RUEHSH/AMCONSUL SHENYANG 4869
RUEHCN/AMCONSUL CHENGDU 0954

UNCLAS SECTION 01 OF 04 TAIPEI 000109

SIPDIS

STATE PLEASE PASS AIT/W, USTR AND OPIC

STATE FOR EAP/RSP/TC AND EB/IFD/OIA
USTR FOR WINTER AND WINELAND
USDOC FOR 4430/ITA/MAC/AP/OPB/JKELLY/MBMORGAN
USDOC FOR 4420/USFCS/OCEA/EAP/LDROKER
USDOC FOR 3132/USFCS/OIO/EAP/ADAVENPORT
TREASURY FOR OASIA/LMOGHTADER
TREASURY PLEASE PASS TO OCC/AMCMAHON
TREASURY ALSO PASS TO FEDERAL RESERVE/BOARD OF
GOVERNORS, AND SAN FRANCISCO FRB/TERESA CURRAN

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E.O. 12958: N/A

TAGS: [EINV](#) [EFIN](#) [PINR](#) [OPIC](#) [KTDB](#) [USTR](#) [TW](#)

SUBJECT: Overview of Taiwan's Investment Climate

¶1. Summary: Septel transmits AIT's mandated annual report with Taiwan's "Investment Climate Statement." Here we attempt to answer a different question: Are local and international investors, especially long-term investors, satisfied with Taiwan's investment climate, looking at both political and economic factors? Are they expanding their presence or moving elsewhere? What does Taiwan need to do, in the opinion of such investors to make itself more attractive? End Summary.

¶2. The direct answer to these questions is that foreign and Taiwan multinational corporations are not fully satisfied with Taiwan's investment climate. Taiwan's investment climate disadvantages are well-publicized by local media that thrive on gloom. Corruption and incompetence of government officials, unemployment, rising personal debt, crime, decline in traditional virtues, and exodus of manufacturing are standard fare in daily news reports. Bitter partisan politics and the shadow of China's military threat further lessen Taiwan's appeal to investors. Restrictions on trade, investment, personnel, and capital flows with China are a nuisance even though these restrictions directly affect only a small percentage share of products and industrial categories.

¶3. Many, if not most, of the complaints from the business sector stem from the tense relations between Taiwan and China. The multinational corporations complain that cross-Strait shipping and air links must go through a third territory (i.e., a place other than Taiwan and China). Cross-Strait travel by air must stop in a third territory. Indirect navigation costs extra time and money. Tedious application procedures are required for sending mainland Chinese-born employees (even those with non-PRC passports) to Taiwan for work or training in their affiliated offices on Taiwan.

¶4. The biggest formal hurdle is that Taiwan-registered companies' investment in China may not exceed 40% of the net

worth. This means a foreign firm registered in Taiwan must limit its activities in China to 40% of its Taiwan capital. The effect for local and foreign firms is to limit growth possibilities to the growth of the Taiwan market. With China growing at close to double-digit rates and Taiwan growth at around 4%, few companies favor tying their growth strategies to the Taiwan market. For American firms that seek to use Taiwan as a platform for the China market, the threshold is just too high.

¶5. Taiwan authorities also forbid foreign companies with mainland Chinese ownership from establishing offices in Taiwan. Taiwan's resistance to absorption by China and its insistence on a cross-Straight financial regulatory agreement have prevented Taiwan banks from setting up branches and subsidiaries on the mainland. Consequently, Taiwan firms in China complain of inconvenience in getting loans and raising capital, and have therefore turned to Chinese or third-country banks for banking services and have listed on Hong Kong and other stock exchanges rather than in Taiwan.

Rambunctious Democracy Cuts Both Ways

¶6. President Chen Shui-bian's 2006 New Year Message prompted further complaints that his replacing "active liberalization, with effective management" with "active management, with effective liberalization" may foreshadow an increase tensions across the Taiwan Strait, resulting in setbacks in cross-Straight economic relations. The change reportedly was an attempt to mollify pro-independence groups in Taiwan. However, many local observers believe that further restrictions on investment in China will lead to

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more Taiwan companies listing on overseas stock markets, and diminishing ties to Taiwan. The President's New Year speech re-enforced the widespread perception that the government is less interested in the health of Taiwan's economy than in partisan goals.

¶5. While divisive, overactive politics are sometimes cited as a factor discouraging investment in Taiwan, its successful transition to democracy is viewed as an advantage over regional competitors. Taiwan's democratic society, free press, and vigorous debate of current issues make it an environment conducive to the sort of critical, creative thinking most valued in an information-based economy. Local businesspeople have cited to AIT the liberal environment as a major quality-of-life advantage that Taipei has to offer over some other cities in the region.

Good International Rankings

¶6. Well-known investment climate indexes continue to rate Taiwan highly as an investment destination. The World Economic Forum in its Global Competitive Report for 2005-2006 ranked Taiwan the most competitive economy in Asia, and fifth highest in the world out of 117 economies in its growth competitiveness index. South Korea, the regional economy most similar to Taiwan, ranked number 17 in competitiveness. The Business Environment Risk Intelligence 2005 report gave Taiwan its highest rating, reserved for low-risk economies worthy of investment. The annual World Competitiveness Yearbook Competitiveness Scoreboard put Taiwan in 11th place out of 60 economies, with Hong Kong as number two and Singapore as number three. These ratings tend to emphasize Taiwan's dynamic private sector businesses, well-developed infrastructure, detailed commercial laws, and relatively open markets.

Open Markets May Slow Foreign Investment

¶7. Taiwan's relatively open markets allow foreign companies

to export their products to Taiwan without the need to establish a physical presence, in contrast to some economies where local manufacturing is necessary to bypass market barriers. The relative infrequency of merger and acquisition cases in Taiwan limits what in other economies is an effective means of attracting foreign direct investment.

¶ 18. Another factor behind the slowing growth of foreign direct investment in Taiwan is the prevalence of indirect investment through foreign shareholding in major Taiwan companies. According to market participants, expectations of a weaker U.S. currency in 2006 have prompted portfolio investors to move huge amounts of capital from the United States to East Asia recently. AIT believes that higher stock prices and a stronger NTD (against the USD) will prevail throughout the first half of 2006, buoyed additionally by the strong attraction of investing in Taiwan's LCD/TFT (flat panel display) industries, which anticipate a very good year.

¶ 19. Taiwan has largely dropped barriers to most types of imports from China and most types of investment in China. About 83% of all trade categories are open to imports from China, basically only agriculture goods are restricted. About 93% of all industrial categories are open for Taiwan investment in China, basically only some high-tech and infrastructure items are restricted. However, as noted in para 4 above, there are stringent limits on the value of investment in China.

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Investment in Taiwan Continues to Expand (Slowly)

¶ 10. Industrial relocation to China has not prevented continued, albeit slow, expansion of Taiwan's domestic investment. Real growth in private investment slowed from 31% in 2004 to as low as 3% in 2005 due to excess inventory stock, and is to reach only 3.6% growth in 2006. The stock of foreign investment has continued to grow every year, up 7% to US\$60.5 billion in 2004 and up another 5.2% to US\$63.9 billion in the first 11 months of 2005.

Trade with China Huge and Growing Rapidly

¶ 11. Liberalization of cross-Straits restrictions has contributed to a steady increase in Taiwan's trade with China. In September 2005, Taiwan's imports from China for the first time exceeded imports from the United States, making China Taiwan's second largest source of imports. Taiwan's imports have grown at a double-digit rate over the past four years. In contrast, the island's imports from the United States have shrunk on a y-o-y basis over the past six months, and the rate of decline has accelerated. China for the first time replaced the United States as Taiwan's major export destination in 2002 when the island's exports to China totaled US\$29,465 million, more than US\$26,764 million from the United States. The percentage share of exports to China steadily increased from 19.6% in 2001 to 28% in September 2005. Meanwhile, the share of shipments to the United States steadily fell from 22.5% to 14%.

Investment in Taiwan as a China Play

¶ 12. A growing number of companies, both local and foreign, are taking advantage of Taiwan's high-quality human resources to staff projects in China. They invest in Taiwan or partner with Taiwan companies in order to gain technical and management know-how, and language and culture advantages that make investment projects in China much easier. The extensive involvement of Taiwan companies in China attracts foreign investors to Taiwan who want to share in the

benefits of China's rapid growth without the high risk associated with direct investment there.

New Factor Discouraging Investment

¶13. Taiwan's new labor pension system and higher taxes that will both take effect in 2006 greatly concern investors because of the impact on operating costs here. Inbound foreign direct investment approved in October and November 2005 reversed from a y-o-y growth of 53% in Q3 to fall 17%. Meanwhile, outbound direct investment approved in October and November 2005 grew 16.4% from a year ago.

Globalization Contributes to Huge Outbound DI

¶14. Like other developed economies, Taiwan has begun to see outbound direct investment exceeding inbound direct investment as manufacturing has moved offshore. Taiwan business firms started to relocate their production bases to Southeast Asia in the mid-1980s and subsequently mainly to China. Meanwhile, foreign investors continue to flow into the island to take advantage of Taiwan's high technologies, relatively liberalized service sector, and as a China play. An additional factor unique to Taiwan is that in spite of its continuing competitiveness on paper (as measured by the investment rating organizations) its appeal to investors has been declining in direct proportion to China's growing

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economic importance and the falling barriers to trade and investment there. The tension between Taiwan and China forces investors to choose between the two to some extent, and the growing favorite is China. While cross-Strait tensions and trade and investment barriers will not disappear overnight, presumably they will eventually. When progress on this front is good, Taiwan looks like a good place to invest. But when progress toward lowering cross-Strait tensions does not keep pace with expectations, Taiwan looks like a lousy place to invest.

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